MANAGING ETHICAL RISK
THE SECURITIES INDUSTRY AND THE LAW

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ABSTRACT

We examine the interplay of markets, ethics and law, and rising demand for ethical behavior in a market driven society coping with the promise and peril of rapid technological innovation. We analyze the market affecting role of our Common Law/Rule of Law System, its adaptability to social need and resultant legal and regulatory action promoting adherence to the spirit as well as the letter of the law. We provide examples of manager and firm harm from sanctions imposed despite adherence to "the rules." Finally, we discuss competitive market/common law interplay in the coming era of the genome.

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INTRODUCTION

> *…a major asset of our nation (is) the integrity of our financial system. Trust is a principle of central importance to all effective financial systems. Our system is strong and vibrant in large part because we demand that financial institutions participating in our markets operate with integrity…When confidence in the integrity of a financial institution is shaken, or its commitment to the honest conduct of business is in doubt, public trust erodes and the entire system is weakened.*
>
> – Alan Greenspan
>
> Testimony before a U.S. Senate Committee, November 27, 1995

In the United States today, both the law and the regulators are demanding an increasing attention to ethical behavior on the part of firms participating in our domestic capitalist system. This is, in substantial measure, due to our society's need for, and rising expectation of, such behavior in the face of the rising power of competitive markets in the life of the body politic.

In Part I of this paper, we propose to explain why and how our Common Law/Rule of Law system allows for effective legal and regulatory responses to social demand and, in essence, promotes adherence to the spirit of the law in addition to the letter of the law. In the process, we will give examples of specific legal and regulatory responses in our time to unethical market behavior illustrating both the insufficiency, and clear inefficiency, of mere compliance with existing rules. In Part II of this paper we intend to confront the extraordinary demands being made upon the law and the regulators, in our Rule of Law system, to honor society's needs and expectations relative to trust, integrity and overall fairness in competitive markets in the face of rapid, and often bewildering technological development. We will focus at this point on the unique adaptability of the common law process, in order to suggest how our legal and financial systems might best adapt to this new century in cyberspace. In our Conclusion, we will note briefly the applicability of our analysis of the markets-ethics-law process in securities markets, to another technology driven, market-related development in our time---a challenge to the law and to regulators so severe as to involve the possibility of substantive change in the fundamental nature of our society.

I. The Common Law/Rule of Law System and Its Response to Some Questionable Securities Markets Behavior

The United States legal system has its roots in the Constitution of the United States. As the protector of constitutional values, the legal system is both values-based and adaptable to change in the interpretation of those values. Adaptability is key to maintaining the integrity of the original constitutional contract.

Our constitutional values, due process and separation of church and state, for example, are permanent at base, but they are not immutable. Such values set forth in the Constitution, as reinterpreted, but never rejected by the citizenry in succeeding generations[1], are the foundation upon which our society is built, and by means of which it functions as it does. And property rights, the freedom to contract, and access to an independent judiciary are examples of the fulfillment of these values. Upholding these values is an obligation, and our financial institutions, no less the citizenry in general, are bound to meet that obligation or risk turning the Constitution into mere pieces of paper[2]. However, the practical, workable shape these values assume, and how they are both protected and enforced, is determined by a free, democratic citizenry in succeeding generations under changing conditions.

The Rule of Law in a Constitutional Democracy must function as the Constitution does: its practical, workable shape must be subject to change under changing conditions. The end of the Rule of Law is always to strengthen and uphold the values inherent in the original contract—by assuring that we and our institutions, including the financial, fulfill our obligations to uphold those values as well.

Our Rule of Law functions through a process remarkably well suited to the task. That process is “The Common Law.” The common law system originated in England and was adopted in the United States. The majority of western nations utilize a different legal process, based upon a comprehensive set of written statutes referred to collectively as a Civil Law Code. The answers to legal questions must proceed from what is within the Code, not from outside it.

The individual statutes can be changed. But until they are, they govern all cases. The following quote illustrates how the common law system differs from a Civil Law Code system:

> Our common law is different. It is generally derived from principles rather than rules; it does not consist of absolute, fixed and inflexible rules, but rather of broad and comprehensible principles based on justice, reason and common sense. Its principles have been determined by the social needs of the community and have changed with changes in such needs. These principles are susceptible to new conditions, interests, relations and usages as the progress of society may require.[3]

Judges make the common law. But they must observe two very important requirements while doing so. First, they must honor *stare decisis* which means literally that they must honor the laws that have already been laid down in very similar cases. But *stare decisis* is not inviolable. What judges who wish to depart from precedent must do is elucidate very carefully good cause to repudiate it. And they are subject to reversal by a higher (appellate) court. Second, judges must reduce all their opinions to writing, so that they are on the record as to reasoning and result. At the trial level there is a full transcript. All appellate opinions are printed and available for reading in law libraries and, more recently, on the Internet. These two requirements assure a satisfactory measure of stability in the law so that people and organizations might have guidance on how to act in legally-related situations.

There are plenty of statutes passed in the United States at the Federal and State level, as well as allied regulations. Nevertheless, our basic body of law is common law based, and the principle of incorporating change when necessary permeates our legal process. The common law, in actuality, is neither loose nor unduly broad for reasons we will soon detail. However, it is certainly more changeable than is civil law. Free, competitive market managers in the United States neglect that reality at their peril, as we hope to demonstrate.

Only Congress can create federal law, and state legislatures state law; however, since no legislative body could possibly deal with every request for bank mergers, or drug releases, or spectrum licenses, nor maintain oversight over all industries, they pass legislation appointing administrative agencies to do so, called enabling legislation. This legislation, to put it succinctly, sets out priorities and ground rules. The administrative agency then fleshes them out.[4] In the face of the large delegations of power to administrative agencies, where lies the common law concern about carefully, but necessarily, taking into account in decision-making the social needs conceptions and concerns of the body politic? That concern, too, lies within the purview of the administrative agency—within the bounds of their congressional mandate. Thus agencies, such as the SEC, deal not only with what brokerage houses and investment banks do in fact (their actual conduct), but with what they ought to do (their ethical conduct) as well.

In sum, we emphasize that in our United States constitutional society, we are involved in a constant attempt to preserve those values that cannot be allowed ever to change. We do so by re-interpreting and reshaping them through our Common Law/Rule of Law process to make them meaningful in a current social context. The values are the ends, the process the means to achieve those ends.

We proceed now to some securities market activities that illustrate the key corollary here: underlying business values such as fairness, integrity, transparency and trustworthiness should not be allowed to change either, although the shape they assume in the current social, technological context certainly may change. The nature of the changes, one might argue, can best be determined by markets and market players. A serious problem there, however, lies in a general market player belief that rules are rules, and playing strictly by them is all the market player is required to do. Consider the following quotation:

> As an anonymous participant in financial markets, I never had to weigh the social consequences of my actions…I felt justified in ignoring them on the grounds that I was playing by the rules…(this) makes it all the more important that the rules that govern markets should be properly formulated. The anonymous participant can ignore moral, political and social considerations, but if we look at financial markets from the standpoint of society, we cannot leave such considerations out. Although we are justified in playing by the rules, we ought to be concerned with the rules by which we play.[5]

The preceding quotation from one of the most influential players in the world financial markets raises two issues. Is it true that all participants in U.S. securities markets are "justified" in playing by the rules even with the knowledge that they are thereby causing social harm? And if participants do believe and act upon that "justification", how then are they to manifest their "concern" about "ignoring moral, political and social considerations" and the social harm they have caused? Ought they to lobby legislators to force them to be ethical?

George Soros, the source of the quotation, has actually shown his concern very clearly by being a very active personal participant in, and major financial contributor to, many positive socio-political endeavors. Our purpose here is not to fault him, but to challenge his dichotomy: that it is "right" to simply play by the rules regardless of any and all political, social, and ethical consequences to anyone, anywhere; however, at the same time, players must be concerned, outside the game, with the nature of such rules as produce morally, politically and socially unacceptable results.

This ethical compartmentalization is not acceptable generally in its determination that behavior demonstrably dangerous to the welfare of others is demanded by business necessity, and protected by rules which were made (or neglected to be made) by representatives of those actually harmed. As a matter of principle, shifting the blame for destructive behavior onto the alleged proxies of those destroyed, is unacceptable outside of markets. For example, terrorist actions against innocent civilians, which the terrorists justify by reference to the active policies of the civilians' own governments, are in turn destructive of the aspirations of the terrorists' peoples. Certainly the dichotomy is unacceptable in a democratic republic where basic values representing the citizenry's choices about how it wishes to live and be governed, are required to be enforced by a socially adaptable Common Law/Rule of Law. One's duty to those values is not waived while one is engaged in the market game, precisely because how that game is played deeply affects the content of those values.

We also oppose another part of Soros' statement, which says that in the fiercely competitive struggle for profits "playing by the rules" is all that can be asked of any participant, or that ethical behavior beyond the rules will cause the actor to be smashed by others who steer clear of ethical action. Our contrary assertion is twofold. First, given the nature and makeup of our common law, any securities market manager who does steer clear of ethical action is not only headed for serious personal trouble, but may well be taking his firm, his stockholders, and even the reputation of his industry down with him. Second, we are convinced that ethical and socio-political insights and skills should be required of every manager with authority to act for his firm in securities markets operations. Such insights and skills are intimately related to the value of the firm, as the following examples help to show.

<u>The Federal Sentencing Guidelines</u>

Until very recently, the idea of holding corporations themselves criminally liable for illegal actions of their employees was subject to much criticism.[6] The actual record regarding corporate conviction for crime shows that prior to the late 1980s and the early 1990s, very few cases were even brought to court. Those that were, were targeted at small companies, not larger, publicly held companies with actively traded stock.[7] The situation changed drastically in 1991, the year in which a major tool for punishing corporations – "Chapter 8" – became the law of the land.

In 1984, Congress passed The Sentencing Reform Act.[8] That law set up a Federal Sentencing Commission charged with developing guidelines to deal with three basic problems: disparity in sentencing for federal crimes, uncertainty in sentencing, and an unjust lack of focus on white collar crime. Some judges, academics and lawyers were critical of the sentencing law for various reasons, but it was declared constitutional in 1989.[9]

Initially, the sentencing guidelines did not deal with organizations. But they went beyond natural persons, focusing on organizational white collar crime, in 1989 amendments which were sent to Congress in 1991. A new chapter was then added to The Federal Sentencing Guidelines: "Chapter 8: The Sentencing of Organizations." That chapter, with all of its provisions, became effective on November 1, 1991.[10] Now organizations themselves could be held responsible for violations of any federal law. There are some 3,000 or so federal laws available for breaking, involving securities, commercial banking, anti-trust, defrauding the government, and many more. The operational market areas covered by the Federal Sentencing Guidelines are broad. Forty-six separate categories of offenses are listed under broad headings; for example, "commercial bribery and kickbacks" is one of six general offenses listed under "Offenses Involving Property." Each offense arises out of a particular area of market operations covered by federal law, as stated above.[11]

Chapter 8 is evidence of official government recognition of an important ethical reality: that much of the illegal action of an organization's employees arises out of the corporate culture within which they function. This is the organizational link to white collar crime. A definition of "corporate culture is to be found in this organizational statement:

> Our corporate culture…is the sum total of what we believe and think, how we work together as colleagues and how we conduct ourselves as individuals. It is the way we treat our clients, our shareholders, our neighbors and the public in general.
> It is who we are. And while our corporate culture is by nature indefinable, it begins and ends with certain principles that underlie our success as a business and as individuals. Our future growth and prosperity depend on our continued commitment to these principles and our ability to instill them in others.[12]

The current government focus on who and what we are – our behavior and the content of our corporate character – is but one example of corporate responsibility going beyond "the rules." The Federal Sentencing Guidelines, according to Deputy Attorney General Eric Holder "enables the government to address and be a force for positive change of corporate culture, (to) alter corporate behavior, and (to) prevent, discover and punish white collar crime."[13]

The Federal Sentencing Guidelines have two distinguishing characteristics. First, they provide very specific penalties for specified violations. Judges must apply these penalties and no others, unless their reasons for deviation are fully explained and justified, in writing; for example, deviation may be allowed on prosecutor recommendations because of the unusual extent of cooperation and assistance by the defendant. There are very few justifications for departing from the Guidelines. Second, the penalty system for organizations is based upon a government commitment to a process best referred to as the carrot and the stick. Penalties are adjusted upward or downward within the mandated categories depending upon the steps the organization has taken, prior to the legal infraction, to avoid criminal conduct, and the cooperation with the government the organization has evidenced once an infraction has taken place. Some attention is also given to the involvement or non-involvement of high level organization personnel in the infraction.

Figure 1 lists offense levels on the left. They are based on the government's harm priorities. Minor offenses are ranked at 6 or less; more serious ones, such as certain anti-trust offenses, can be ranked as high as 38 and above. The dollar fines are shown in the right hand column: as little as $5,000 for a minor one, $72,500,000 for a very serious one.

Because of the carrot and stick approach embedded in the Guidelines, a level 38 infraction would not be likely to result in exactly $72,500,000. That figure would probably be adjusted up or down. The direction of the adjustment would be determined by several factors, particularly those set out in the second characteristic discussed above. Past infractions of federal law are also taken into consideration. All those elements are, together, the basis for what is referred to as the organizational "culpability score." The culpability score ranges from a low fraction up to 4. If a particular corporate crime is at level 38 or above, and the culpability score is at 4, the total fine for that one infraction then would be $290,000,000, an amount calculated to send a clear and convincing message. Conversely, there are actions the corporation might have taken that would mitigate the

Figure 1 CORPORATE FINES

Offense Level	Amount
6 or less	$5,000
7	$7,500
8	$10,000
9	$15,000
10	$20,000
11	$30,000
12	$40,000
13	$60,000
14	$85,000
15	$125,000
16	$175,000
17	$250,000
18	$350,000
19	$500,000
20	$650,000
21	$910,000
22	$1,200,000
23	$1,600,000
24	$2,100,000
25	$2,800,000
26	$3,700,000
27	$4,800,000
28	$6,300,000
29	$8,100,000
30	$10,500,000
31	$13,500,000
32	$17,500,000
33	$22,000,000
34	$28,500,000
35	$36,000,000
36	$45,500,000
37	$57,500,000
38 or more	$72,500,000

offense level, say down to 28. Given an insignificant “culpability score,” the total penalty could be, say, $10,000,000 rather than $290,000,000, a rather significant savings.

One major before-the-fact mitigator is the existence within the organization of “an effective program to prevent and detect violations of the law.” There are 10 elements that make up such a program, and they are contained in the Guidelines manual—a publication with which all corporate compliance officers are intimately acquainted. The elements encompass compliance standards and procedure; oversight by high level personnel; due care in delegating authority; effective communication of the program within the company and steps taken to achieve compliance. Included here is a “reporting system” employees might use without fear of retaliation, to encourage whistleblowing. There are other elements, but the key is to have the organizational efforts so focused on prevention and detection as to constitute “due diligence.”[14]

Of course, the government cannot force any private employee into having such a program as described before the fact. But after the fact, in addition to the severe, unmitigated penalties that could be levied against the firm, a program can then be forced upon it. This brings us to the supreme organizational punishment, not listed in Figure 1. It is called “Probation.” Organizations, in practice, go to very great lengths to avoid it, even agreeing to pay high dollar fines. An organization placed on probationary status for serious infractions will be forced to put “an effective program” in place; could be assigned an overseer appointed by the government to remain on site for a specified period of time to watch over the new program and even more general corporate activity; will have to make books and records available to the government on demand; and will be held to making all penalty payments in full and on time.

The Guidelines apply to all infractions of federal law subsequent to November 1, 1991. They are, to our knowledge, the only such body of law in the world focused on corporate behavior and calculated to motivate the maintenance of a corporate culture that actively promotes lawful and ethical behavior. The word “ethics” does not appear specifically in Chapter 8. However, on the ground, in actual practice, government regulators are very much affected by the presence, or the absence, of a corporate code of ethics which actually provides support for the corporate compliance program.[15] The reason for this practical ethics requirement has been stated succinctly by the author of the most important legal treatise extant on compliance programs and the organizational sentencing guidelines:

> The dynamic nature of business crime also suggests that no compliance program can truly be effective if it neglects the broader subject of ethics. With laws (or the interpretation of laws)

> subject to change on little notice, ethical reasoning and instincts can act as an all-important safety net. A purely legalistic approach, by contrast, may ill serve not only ethics, but compliance itself. A limited approach may also be unsatisfying to many employees as well as to others in a company's community-such as customers.[16]

The Organizational Sentencing Guidelines, however, do not substitute the corporate offender for the individual offender. The complete Federal Sentencing Guidelines punish both, severely. In fact, corporate punishments can be mitigated when, in a timely fashion, the corporation cooperates with the government by self-reporting its offenses and discloses to the government all pertinent information sufficient for law enforcement personnel to identify the individuals responsible for the criminal conduct. In other words, employees who continue to believe that they are acting properly as long as what they do satisfies the prevailing corporate behavior standard ("meet that bottom line if you want to succeed, no matter what") are in for a rude awakening and serious personal punishment when that same corporation suddenly hangs them out to dry. Jail time is very often their fate.

The Federal Sentencing Guidelines pose enormous risks for business and for individuals when the rules are broken and make very clear as well, that ethical behavior beyond specific legal requirements plays an important role in how, when, and to what extent the sanctions attached to those rules are applied. The Soros dichotomy would hardly hold up here, either for the firm or for the individual.

In 1999, in addition to bargained and settled organizational cases under the Guidelines, 255 organizations were sentenced under Chapter 8, a 15.9% increase from 1998. Fines were imposed on 200 organizations. The sentenced organizations pled guilty in 91.4% of the cases; 8.2% were convicted after trial. One defendant pleaded *nolo contendere*. As in 1998, fraud was the most frequent offense committed by an organization. The highest fine in 1999 was $500,000,000.[17] Some 56,000 individual defendants were reported to the Commission under the Guidelines in 1999, up from some 51,000 in 1998. The second most frequently applied of the guidelines, behind drug trafficking, was that pertaining to the crime of fraud.[18]

It only remains to be pointed out that neither the Federal Sentencing Guidelines, nor any other legislative responses to societal concerns about unethical market behavior are "civil law" responses. They are the legal result of a common law process whose basic purpose is to eschew the civil law function of reducing all behavior to inviolate rules.[19]

While many securities firms have run afoul of the Sentencing Guidelines in such areas as insider trading and other forms of fraud, such as the Salomon Brothers traders' attempt to corner the Treasury Bond Market, we complete this section of the paper with some examples of seemingly within-the-rules behavior of securities firms specifically, which raise ethical issues and legal issues as well. We also note how in some cases these practices are triggering the common law process discussed above.

IPO "Spinning" and Special Commissions

In the world of Wall Street "spin desks" (as of 1997):

> Many investment banks silently allocate chunks of hot new stocks to the personal brokerage accounts they hold for corporate executives and venture capitalists – "spinning" or "flipping" the shares on the day of the IPO for quick profits – in an apparent bid for business from the executive firms…'At its extreme an IPO is priced Wednesday. Thursday morning you call 25 venture capitalists and say: "by the way, XYZ just went public at 15. It's now 30. You just sold your allocation at 29 ½. I hope you're happy.'[20]

Should this kind of spinning be looked at as a *quid pro quo*? If so, the executive who takes the profit has to deal with the issue of breach of fiduciary duty. Fiduciary duty posits a very special relationship between principal and agent. One aspect is that the fiduciary has an affirmative duty not to profit by virtue of his position as a fiduciary; another is an affirmative duty to disclose to the principal any and all information in his possession that bears upon any decision the principal is to make. Both duties are inconsistent with taking spin money as, say, a chief financial officer of X Company, or helping to decide on using the spin profits' investment bank to underwrite X Company's new stock issue.

Many firms who spun and then "flipped" IPO stock for major firms' officers (turned it over quickly for a profit) had been preventing lesser customers of the firm, who manage to get a small piece of an IPO, from "flipping" the very same stock. The method used was to inform all of the firm's brokers that if their regular customers do not retain their stock for 20 or 30 or however many days, then the broker loses his commission on the original sale.

The "spin" broker's refrain is of course, "everybody does it and they always have." Inevitably, one of society's message bearers, in this case in the form of the Wall Street Journal, exposes the practice to the light of day for all those in and out of the game to see, and with easily perceivable distaste. The "justice, reason and common sense" of the common law process is set in motion, and the SEC is now investigating the process. State securities regulators have also come down heavily on spinning as a "dishonest and unethical business practice" that puts the firm's brokers in direct contravention with the financial interests of their customers. Massachusetts regulators have charged brokerage firms with wrongdoing here and stated that "requiring firms to abandon (these) policies is one of the more severe sanctions we will impose."[21] It would be overstating the case to say that spinning is now extinct. However, if not abandoned, spinning is down by a considerable degree. And those who insist on playing that game are now opened up to lawsuits, in which the "rules" will be no defense.

Finally, in connection with IPOs, there is the issue of just how broker-dealers make allocations of these (at least, formerly) "hot" stock issues. The "rules" would seem to have been clear: how broker-dealers allocate IPOs, or any stock issues, is strictly their business. But it is now alleged that in order to obtain shares of hot IPOs, some investors paid hefty stock trading commissions, well above the going rate, to particular broker dealers. According to the SEC, this might be interpreted as commercial bribery -–a whole new slant on the good old "rules," and a clear response to strong ethical concerns. If, in fact, the mass of consumers were frozen out of hot issues because hefty commission agreements were key to obtaining the money-tree IPO issues, social concern is clearly warranted. Whether or not the SEC can prove direct connection between fee and allocation is not necessarily the issue: tons of documents have been subpoenaed, United States and New York City prosecutors are investigating and the securities industry has suffered another blow to its already damaged image.[22] Clearly, there is a sizeable group of Wall Street defendants, former employees and sensitized working managers who have, quite recently, observed at close hand this example of the common law process at work. There are two other examples:

<u>"Soft Dollar" Services</u>

Investment managers often get an array of services from many brokerage firms to whom they give their business. It has even been estimated that the soft dollar brokerage business accounts for as much as 40% of all stock trading.[23] Soft dollars are certainly not all unethical. Some of the higher commissions (soft dollars) paid to brokers result in an investment manager being provided with valuable extras, including independent research such as stock reports and data feeds, which do not come automatically with purchase and sale execution. That is not a kickback from the broker; rather, it is a return for the higher commission paid. However, investment managers rarely inform their clients that they are actually paying higher than normal broker fees, nor, certainly, what they are getting in return. This becomes a problem when the broker returns part of the excess fee in the form of payment for new top-of-the-line furniture for the manager's office.

The result of public exposure to the soft dollar phenomenon was an 18 month sweep of 250 investment advisors and 7 broker-dealers by the SECs Office of Compliance. The concern of Chairman Levitt went beyond excessive commission rates to such areas as the overtrading of accounts, and inferior execution by less efficient brokers to satisfy a soft dollar obligation. These are unethical behaviors, failing the test of fundamental fairness to one's customers. Subsequent to the compliance report, the SEC moved to tighten up section 28(e) of the securities laws, which does not prohibit soft dollars *per se*. Full disclosure to clients is the watchword now and, in the case of the $5.5 trillion dollar mutual fund business, better disclosure to investment advisors' boards.

Securities "Clearing Firms" and Responsibility For Activities of Their Customers

Clearing firms are trade processors. They are large brokerage houses which are hired by smaller firms, called introducing brokers, to execute trades for them, maintain client records, send out trade confirmations and monthly statements and also settle the smaller firm's transactions. By this clearing firm arrangement, the introducing broker is able to use the cachet of the powerful, well-known firm, and the powerhouse firm is able to make a tremendous amount of money. The clearing firm requires introducing firms to put up a deposit, usually some $250,000. It also levies a "ticket charge" of $10 to $25 on each trade it conducts for the introducing broker. It also charges interest, usually 1% per month, on margin loans it makes to these customers.[24]

Since 1982, when commissions were deregulated, clearing firms have not had legally determined oversight responsibilities for their introducing brokers. The operating principle has been to provide the service and earn the money for any introducing broker who hasn't yet been thrown out of the business. The ethical character of the still-in-operation introducing firm was not regarded as the business of the clearing firm in any way; that is, no rule existed stating that it was.

Then A.R. Baron & Co., an introducing broker to its clearing broker, Bear Stearns & Co., went bankrupt. Baron was also charged by the Manhattan (New York City) District Attorney with being a criminal enterprise that defrauded investors out of 75 million dollars. Bear Stearns, whose clearing operations represented more than 25% of its multi-billion dollar business in recent years,[25] came under fire in connection with the A.R. Baron debacle. Bear Stearns cleared for Baron in 1995, when Baron's credit was so bad it was unable to qualify for a corporate gasoline credit card. In that same year, Baron paid $1.5 million in fines in an NASD settlement where it was alleged that it executed trades for customers at unfair and unreasonable prices. By the end of that same year, Baron's capital fell below the regulatory minimum. Additionally, a Baron customer notified Bear Stearns of unauthorized trading in its accounts. Bear Stearns simply referred the matter back to Baron. In October of 1995, Bear Stearns injected $1.1 million of its own money into A.R. Baron to keep it afloat when its capital once more fell below the statutory minimum. The SEC ordered Baron to halt all operations in May, 1996. It filed for bankruptcy two months later, and less than a year after that came under formal investigation by the Manhattan District Attorney.[26]

By early June of 1997, the NYSE and NASD had their officials meet with several clearing firm officials. One firm, Oppenheimer & Co., announced plans to stop processing trades for any introducing broker client accused by regulators of charging excess commissions.[27] Bear Stearns' position was that a clearing broker had neither access to, nor control over, any introducing broker, and if subjected to customer claims, might well get out of the business altogether.[28] The SEC then let Bear Stearns know it was preparing to consider making civil securities fraud charges against it, with attendant Sentencing Guidelines penalties if the U.S. Attorney went further with criminal charges. A settlement was reached, with Bear Stearns agreeing to pay a fine, and restitution to A.R. Baron customers of $25 million. The agreement apparently was that Bear Stearns "contributed to" A.R. Baron's activities—something short of "aiding and abetting" fraud. Bear Stearns' senior executive in charge of its billion dollar a year clearing business, Richard Harriton, later resigned.[29]

The key question here is not why Wall Street firms would accept no responsibility for introducing brokers actions for a long time; rather it is how could a major investment bank fail to see changes blowing in the wind? Hubris may well be part of the answer. But an argument could be made that Bear Stearns' admittedly strong compliance culture (nobody here is allowed to actually break the law), did not focus on ethical sensitivity at all. The notion that all action still legal is *per se* ethical and beyond punishment, is not true in fact. What is true in fact is that the Common Law/Rule of Law system assigns basic duties of care to those who are paid to provide skilled services to others for a fee. And the definition and application of these duties are susceptible to change – "to new conditions, interests, relations and usages as the progress of society may require."[30] As between the consumer and Bear Stearns, the duty to take due care to be informed about the behavior of the introducing broker, and to act responsibly (that is, ethically) to avoid harm, ought to be upon Bear Stearns, and any other clearing broker.

II. The Common Law/Rule of Law System, Securities Markets Behavior, and the Technology Explosion

Online trading is a coverall term for securities transactions entered into and completed on the Internet using computer processes. The advent of online trading has already changed the structure of the securities industry. According to recent data, more than 6.3 million U.S. households had online trading accounts as of April, 1999.[31] Online transactions in 1998 rose from less than 11% of total stock trades in the first quarter to 13% in the fourth quarter. Given that 400 billion shares of stock were traded on U.S. exchanges in 1998 (and far more since then), that percentage constitutes a lot of cyberspace transactions. And according to *The Wall Street Journal* (1999) the top 10 trading firms control over 91% of the total business.[32]

The advent of online trading has also changed the nature of the broker-client relationship. Prior to 1997, technological inefficiencies in the market had provided only fast acting professionals in possession of equipment and access to data with the opportunity for rapid daily profits. Then came the NASDAQ bid-ask (point) spread collusion scandal, which had two important results. First, the many brokerage firms allegedly involved in maintaining wider point spreads in order to heighten profits paid out more than $1 billion in settlements. More important, new NASDAQ Trading Rules were put into effect, providing greater data access to non-professionals through more prominent display of their stock orders on the NASDAQ system. Day trading could now become a game for everyone.

Many customers trade on the Internet much as they would on the ground: with a broker's advice, or data provided by his or her firm, with an eye toward risk tolerance, present financial position, ultimate investment goals, and some substantive information on the companies in which they invest. But there are also “day traders,” whose goal is immediate profit. They often know nothing at all about the company whose shares they buy and sell, other than the direction in which they and their industry as a whole perhaps have been moving. And trading as they do several times in a day, they may well lose sight of their current financial position.

The question now, put simply, is the following: given the changing nature of broker-client relationships in cyberspace, what are, and what ought to be, the rules in this awesome new game? Beyond that lies an even more difficult question: what new shape might this game assume – perhaps shapes would be more realistic – and what are we to do about rules then?

It might be argued that we are in a brave new world in securities trading now, where the true ethic is “assumption of the risk”: we are all fully responsible for our choices, win or lose, and broker-dealer duty does not go beyond performing all mechanical functions with some reasonable degree of care.

An ethic calling for the consumer’s full and complete assumption of the risk is no ethic at all. It is nothing more than an excuse for intransigence by those who would argue for a right to be paid highly for their expertise, in the face of a disappearing correspondent duty. And to negate meaningful duty to investors in the presence of technological leaps would be to argue that constitutional values are now outmoded—perhaps, even, that now is the time for a new, electronic constitution.

This is a less than convincing argument to us. While we have no ability to predict the future of securities markets in cyberspace, we are able to extend to cyberspace the issues already giving rise to questions of law and regulation. Our position is that the Rule of Law will prevail, even on the Internet. If it does not, competitive markets as we know them now will cease to exist, and meaningful discussions on the issue of securities will be limited to self-defense and survival. This is not to say that our basic constitutional values will not take new workable, practical legal and regulatory shapes that cannot now be foreseen. But if private property rights and the sanctity of contracts are to prevail, so must fundamental fairness to the free citizens of a democracy.

Outside of cyberspace, where almost all of us still live and conduct our business, there are legal and ethical constructs for promoting proper behavior in broker-client relations. All stockbrokers, mainly because of the asymmetry of information that exists between the buyer and seller of securities, have some form of legal duty to every single client. The extent of that legal duty depends on two central factors: the nature of the service relationship between the parties with regard to the transaction being done, and the extent of the information asymmetry between them.

A broker receiving a simple buy order from a sophisticated client has a duty to that client. But it is limited to the quality of execution only: proper timing and price. How that stock performs is the client's risk, not the broker's. At the other end of the scale is the elderly widow, completely lacking in market experience, who comes to a broker for advice on how to invest her nest egg which is now $250,000 in bank CDs. Even here the broker's duty may not be at the level of fiduciary; however, the broker had better get a lot of information on this widow's preferences, risk profile, total assets and the like before making his investment recommendations. The duty of care here is far higher than to our first client. And if the broker is handling a "discretionary" account in which she has full authority to buy and sell for the client's portfolio according to the broker's best judgement only, with no need for permission to make specific trades, then the broker's duty is fiduciary, and that is a very high duty indeed.

Given the varying duties of care on the ground then, how ought the law and the regulators deal with these duties in cyberspace; that is, online? An investor choosing to invest online with the advice and assistance of a broker is entitled to broker duties of care equal to any on-the-ground transaction. For example, the New York Stock Exchange requires that brokers know their clients' overall goals, risk preferences and time horizon before they execute an order, whether they recommend the particular transaction or they do not. This is referred to as the "suitability" rule. The NASD holds brokers firmly to a suitability rule when the seller has recommended the transaction, and is considering enlarging the duty to all transactions in cyberspace. To what level of legal duty, exactly, should an online broker, lacking the normal on the ground client relationship, be held? How about on-the-ground brokers operating in cyberspace as well? Is their level of duty different?

A sizable percentage of arbitration cases in which customer-buyers prevail are based presently on "unsuitable" investment grounds. In the face of any meaningful market retreat, the ethical and legal issues of "knowing" and "suitability" could bring about an intolerable load of damage claims.

It is difficult to contemplate a brokerage firm of any kind of making money for themselves in the absence of any duty to act in their clients' best interests and in an informed fashion. Certainly, what is reasonable in cyberspace may require different suitability rules depending upon the nature of the relationship; however, whether it be mandatory pre-trading customer information filing, trade blocking for particular customers of specified risky investments, or something else, some duty of suitability must be implied, even in cyberspace, in a form dictated by two things: first, the presence of transparency, honesty, and non-misleading behavior—the hallmarks of the fairness and trustworthiness value; and second, reasonable accommodation to the new structure and function of existing technology. As long as we continue to live under a Constitutional value system upheld by the Rule of Law through the Common Law adaptability process, we will find ways to efficiently utilize technology in an out of cyberspace, without negating meaningful duties of care owed to the public by market managers and those they supervise. If technology is allowed to pull beyond the Rule of Law, we might survive that event as well—but not as residents of a constitution-based, democratic republic.

There are many issues to be faced in the new world of technology driven securities markets in addition to that of the broker-dealer duties of care to investors. Much of this burden will fall, as it has in the past, on the regulators. Regulators seeking to ensure the continued development of the wealth creating function on the one hand, and the fairness and integrity and safety of the markets on the other, are faced with a formidable task in a cyberspace with, as yet, indefinable dimensions. In the face of technology developing exponentially, how does one keep one's legal and ethical bearings? The editor of a Wall Street magazine put the problem for regulators somewhat in perspective:

> Regulators are having as tough a time as everybody else trying to figure out what their new priorities should be. We all need to move more carefully-There's too much at stake from the livelihood of market makers to the health of the nation's economy.[33]

We argue that there are three general, but crucial considerations that relate to the coming regulatory task in the securities market area. First, technology driven market change has outrun our capacity to comprehend fully the meaning of what has already happened in our securities markets, much less what ought to be happening in the future. Second, we face great difficulties in doing cost benefit analysis regarding individual regulations in the presence of conflicts between efficient markets and democratic values. Finally, we must continue to deal with the reality of both politician and regulator conflict of interest, and self-regulating organization conflicts as well.

To begin at the beginning: while our regulators do not truly understand the present or future state of securities markets, they must act as if they really did. Questions of fairness, efficiency and safety must be faced since, every day, trillions of dollars, marks, pounds, euros, francs, yen and such continue to change hands in various ways all around the world with some effect, surely, on "the public interest." And in addition, tremendous numbers of players feel justified in arguing that public interest is irrelevant to them on the ground that they are playing by the existing rules. Any argument that we should forgo all regulation, let the market sort everything out for itself until equilibrium is reached, and in the meantime, "*c'est la guerre*," is nothing short of preposterous.

How, then, to proceed realistically in the whirlwind? We suggest utilizing a sensible general approach to working in the face of uncertainty:[34] regulators ought first to examine where current securities markets changes appear to be taking us. They are pointed in the direction of rapid institutional and product development, and diffused delivery systems, surely. These changes create unique opportunities for creating wealth—and for increasing worldwide competition, and risk as well.

As an example of such a change, we focus on one final development: the stock exchanges themselves are in the process of changing their forms and possibly their responsibilities. We have reached the stage where a four year old computerized stock trading service (an ECN or "electronic communications network") has applied to the SEC to become a brand new stock exchange,[35] and many other ECNs are waiting in the wings to apply as well. The SEC is studying the issue, and could well grant such an application. In 1999, the SEC rule referred to as "Reg ATS" took effect, which allows alternative trading systems to become stock exchanges. That regulation is focused on the probability that ECNs would be good for market efficiency by dint of rapid innovation and lowered transaction costs.

How should these cyberspace stock exchanges be regulated? And by whom? Should they largely regulate themselves as self-regulating organizations? To what duties must they hold themselves? SEC market regulators know the truth of one market exchange expert's recent remark:

This is not a revolution.
It's an earthquake[36]

It must be pointed out that the three major exchanges (NASDAQ and the American Stock Exchange being combined, however) are not unaware of the challenges they are facing. Since ECN financial ownership, currently, comes from sources dependent on NYSE listing and liquidity, that exchange is less immediately threatened than NASDAQ-ASE. Nevertheless, the NYSE is seriously contemplating becoming a for-profit company selling its own shares to the public. The focus is on removing the existing, entrenched power structure that holds back change, and creating a sizeable pool of funds with which to buy, most likely, ECNs themselves. The NASD is also contemplating spinning NASDAQ off as a private for-profit company and selling shares to the public as well.[37]

Fragmented securities markets, such as are suggested by the ECNs, must surely point regulators in the direction of conflicts of interest. Best execution and best price, for example, from a brokerage-owned ECN, may not be forthcoming. One might also ask whether a publicly owned NYSE, with self-regulating powers, could be truly dependable and fair to all customers in the face of the Wall Street imperative to make as much money for its owners, right now, as possible without breaking current law.[38] These conflicts emphasize the need to consider "which entities should be allowed to own which others" equally with "how best to police conflicts of interests in an unfettered ownership market." One might answer that there's no need to worry about exchange operators since self-regulating organizations and the market itself will take care of all serious funny business. That answer represents, at best, the triumph of hope over experience.

Self-regulating organizations have, of late, shown disturbing weaknesses. In addition to the NASD lapse, 1999 saw the securities industry's number one SRO-the New York Stock Exchange – publicly chastised for oversight failures. What the NYSE missed was the existence of illegal trading on the floor of the exchange. Floor brokers executing orders in an account were allegedly sharing profits from that account as well. Four NYSE floor brokers also pleaded guilty in a federal court to a conspiracy to place trades to benefit themselves and not their customers. The result of an SEC investigation was the institution, by the NYSE, of several new regulatory initiatives, including a system that will enable the exchange to reconstruct any trade or cancelled trade from beginning to end.[39]

It does not belittle the generally careful and laudable oversight of the NYSE and the NASD to note the possibility that when oversight problems do arise, they could be related to an overly protective watcher stance with a bit too much regard paid to the interests of the watched rather than their customers.

As previously mentioned, there are, of course, other issues to be faced relative to how law and regulators ought to respond to securities markets and expanding technology issues. They are, for the most part, however, more complicated aspects of issues that are faced on the ground already: determining the costs and benefits of any regulatory action; dealing with regulator turf issues (how do we prevent overlap and internecine regulator warfare), especially after the repeal of Glass-Steagall, when banks, brokers and insurance folk will be combining, even in cyberspace; and finally, dealing far more forthrightly than we have to date with the issue of what internal regulator conflicts of interest interfere with proper regulatory functions.[40]

Dealing with these three issues, even in the absence of cyberspace technology has not been – and still is not – easy. Competing scientific, political, economic and public social concerns, such as those regarding environmental policy, must be considered and weighed constantly, and judicial and regulatory responses fashioned, albeit in a manner and at a pace that would certainly unsettle civil code adherents. Our trump card has always been an established culture of public interest protection arising out of our Rule of Law and its Common Law adaptability process. And will continue to be, even in cyberspace, as long as our original constitutional contract is observed.[41]

III. Conclusion

We have attempted, in this paper, to show how our Common Law/Rule of Law system allows for effective legal and regulatory responses to social demand and, in essence, promotes adherence to the spirit, as well as to the letter, of the law. And we have argued that this socio-legal process demands ethical behavior often beyond the boundaries of rules, which, if lacking on the part of securities firms and their managers, could cause great harm to these managers, to their firms, and to the body politic.

Maintaining this law and regulatory system in the face of rapid technological development will be ever more difficult, but ever more essential, if we are to protect and preserve the Constitutional value system upon which we all depend for safety, growth and fulfillment, whether as individuals or as business firms. This is true in terms of financial markets certainly, but not in terms of financial markets alone.

Recognizing and acting on the reality that our market behavior must be ethics-based as well as rules-based, and that our legal and regulatory system must continue to promote that behavior, is imperative, surely, in the face of the scientific technology based genetic revolution as well. Many competitive markets, commercial and investment banking, brokerage, insurance and health care markets particularly, are already becoming involved in genetics based commercial activity. Here now, or coming relatively soon, are such areas as genetic testing for predisposition to genetic disease; gene therapy focused on present disease states (somatic therapy); gene "therapy" focused on "normal" states (germ cell therapy) encompassing everything from the choice of physical and perhaps mental characteristics of one's offspring, to the act of cloning humans. Much human progress is in the offing but much danger is there as well.

Competitive markets, science, religion, and society itself will demand decisions requiring both human and governmental action beyond anything ever dreamed of as little as 50 years ago. How we as a Constitutional, Rule of Law society resolve the rules and ethical "ought tos" in terms of our behavior in securities markets, genetics markets, and others, could go very far toward determining not just the financial and economic, but the moral shape of humanity as well in the 21st Century and beyond. It would be presumptuous of us to state unequivocally that the awesome promise of 21st century genomics could never be overshadowed by technological and market driven genetic engineering, much closer to dreadful gene tuning eugenics than to good health; or that a profusion of competing stock exchanges, or presently unforeseen institutional combinations, and trading methodologies of incredible volume and speed, could not bring about a weakening of duties of care and consumer protections as would have us functioning under an eventually intolerable burden of social and financial risk. And this is to name but two of many possible, if not probable, technological, financial and natural science advances that could present our nation with the dazzling promise of human betterment – and the reality of wrenching, negative, socio-political, democracy-denying change.

Maximum Liberty and Justice, in the face of Minimum morality, is impossible. And law alone cannot change that reality. However, with what we believe is a realistic view of our nation's past and present, we have great confidence that we will, in our future, extract far more of the good than of the bad from science, from technology and from our competitive market system. The story is told of Benjamin Franklin leaving Independence Hall in Philadelphia after the delegates' work was completed, and being asked by an anxious matron, "Well, Sir, what sort of government do I have now?" And Franklin replying : "A Republic, Madam, if you can keep it."

Well, we have kept it—with some moral lapses, to be sure. We are a democratic republic, not a Utopia. But there is, in our body politic, an imbedded values system arising out of the original constitutional contract. We are not a minimum morality nation.

What we have tried to do in this article is to set out what we believe to be an essential ingredient in the preservation of that value system, particularly in the face of a total change dynamic greater than we have ever seen before, a dynamic which cannot help but challenge our democratic institutions. That essential ingredient is our Rule of Law, upheld through our Common Law process. It is an adaptable process that evaluates and acts upon the essential fairness of individual and institutional behavior—what it ought to be, as well as upon present, strictly rule-based conduct set out at some earlier time. The Common Law/Rule of Law process exerts a powerful demand for integrity on the part of individuals and surely market institutions, for behavior that is trustworthy, fair and public confidence building.

We believe that examples we have given in Parts I and II of this paper model the effectiveness over time of this "essential ingredient." They should help to assure us that, if we all do our part to strengthen and preserve it, our Rule of Law will allow us to incorporate the benefits of progress while retaining our essential commitment to Liberty and Justice for all.

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Footnotes

[1]With one important exception: the abandonment of the original concession to slavery-a value well disposed of, and specifically replaced by the prohibition of slavery (13th Amendment, 1865), and the protection of basic constitutional rights in the face of any state attempt to abridge or deny them (14th Amendment, 1868).

[2] That situation has been the lot of many nations around the world who have had several incarnations of such pieces of paper, without ever effecting through them a value system capable of producing and sustaining a Rule of Law—to the great detriment of their financial systems, one might add.

[3] Gifis (1991), page 82, citing the judge in 37 N.W.2d 543, 547.

[4] For example, Congress has never defined "insider trading," leaving it up to the SEC and the courts to define it within the broad, statutory limits.

[5] Soros (1998), pages 196-197.

[6] See Schlegal (1990), especially Chapter 1.

[7] See Bear and Maldonado-Bear (1994), pp. 406-407.

[8] Public Law 98-473, now codified in various sections of 18 U.S.C. and 28 U.S.C. (1988).

[9] Mistretta v U.S., 109 S. Ct. 647 (1989).

[10] The Sentencing Guidelines Manual, Section 8, intro. Cmt. (1998). "Organizations" is defined as including every possible combination: corporations, partnerships, unions, trusts, pension funds, etc.

[11] Sentencing Guideline, note 17, supra at Section 8A 1.2, "Commentary" and section 3(K) 1-7 (iii), "Application Notes."

[12] From The Merrill Lynch Principles, reprinted in Casey, (1997) pages 232-235. See also Jackall (1988) for corporate culture's clear effect upon the actions of individuals functioning within it.

[13] U.S. Dept. of Justice Memorandum (1999), as modified 3/9/2000.

[14] See Kaplan et al., Compliance Programs and the Corporate Sentencing Guidelines (Clark, Boardman, Callahan, 1994 at section 3.19).

[15] From the authors' personal contacts with U.S. Government officials attached to the Securities and Exchange Commission, the Office of the U. S. Attorney for the Southern District of New York and the Division of Procurement of the Navy Department.

[16] Kaplan et al., "Living With the organizational Guidelines," Buchanan et al., Cases and Materials In Markets, Ethics and Law (Simon and Schuster, 1998). See also Paine (1997), pages 91-97.

[17] United States Sentencing Commission (2000), 1999 Annual Report, Chapter Five, pages 45-47. More than one offense can exceed the $290,000,000 figure cited in the text.

[18] United States Sentencing Commission (2000), pages 42, 44.

[19] See Kaplan et al at fn .15, supra.

[20] Siconolfi (1997c).

[21] All quotes are contained in Siconolfi (1998).

[22] See Pulliam, Smith, and Gasparino (2000).

[23] Taylor (1995).

[24] The figures are from a table in Morgenson (1999a).

[25] Smith (1999).

[26] The Bear Stearns story is fully and dramatically detailed in Morgenson (1999a).

[27] Siconolfi (1997b).

[28] Siconolfi (1997a).

[29] See Gasperino (1999). Mr. Harriton has also issued a public defense of his actions based on two arguments: first, he was playing by the (then current) rules and there's nothing wrong with that; and second, the SEC also knew Baron was doing wrong and they did nothing, either, encouraging him to remain as Baron's clearing firm. See "Fraud at Bear Stearns? Two Views,"the Wall Street Journal, September 1, 1999 at page A26. Harriton's first argument is not likely to help him, but the second argument is interesting if it's 100% accurate.

[30] See fn. 2, supra.

[31] Henriques (1999) offers the Securities Industry Association, Credit Suisse First Boston and the SEC as sources for her figures; Buckman (1999), at 3.7 million, cites Forrester Research for her figures. In her story, however, another analyst is cited as using the figure of 7.3 million on line accounts with Charles Schwab and Fidelity Investments claiming 5.5 million just between them. Dugan (1999) claims that "one in 4 trades is executed on line." The bottom line seems to be that nobody seems to know for sure exactly how many on line accounts exist, or how much total trading (money) they account for. But one answer surely must be: a lot!

[32] The Wall Street Journal (1999). The 10 trading firms, listed in order of market share, from 27.9% for #1 to 1.3% for #10 are: Charles Schwab; E*Trade; Waterhouse Securities; Datek Securities; Ameritrade; DLJ Direct; Discover Brokerage Direct; Suretrade; and National Discount Brokers.

[33] John Byrne, editor of The Trader, quoted in Henriques (1999).

[34] Hughes (1999).

[35] The applicant is Island ECN. Some 19 other ECNs are waiting in the wings, including a "super ECN" formed by a Bloomberg subsidiary and ITG. An excellent examination of the fast changing stock markets landscape is Ip (1999b).

[36] Professor Robert A. Schwartz, quoted in Henriques (1999).

[37] G, Ip, note 67, supra. See also Sloan (1999).

[38] See Morgenson (1999b).

[39] See Ip and Shroeder (1999a, 1999b).

[40] Regulator responsibility is a subject of enormous importance, not sufficiently related to in academia. One who has done so both forcefully and well is Kane (1997).

[41] On thrashing out environmental cost-benefit issues, see Bear and Maldonado-Bear (1994), pages 138-156. See also Sunstein (1997), Chapter 10. And on the issue of judicial control of regulatory overreaching, see Board of Governors of the Federal Reserve System v. Dimension Financial Corp. et. al., 474 U.S. 361 (Supreme Court of the United States, 1986).